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No. ____

In the Supreme Court

OF THE

United States

OCTOBER TERM 1984

BATEMAN EICHLER, HILL RICHARDS, INCORPORATED,
Petitioner,

vs.

CARL F. BERNER, et al.,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTIONS PRESENTED

1. Should the common law *in pari delicto* defense bar implied private actions under the federal securities laws by an admitted tippee-securities law violator against the alleged tipper because, as all of the reported decisions of the courts of appeal except that of the Ninth Circuit have concluded, (i) the defense implements a wise and historically proven policy of the common law against rewarding wrongdoers and (ii) preserves the integrity of the securities markets and the judicial process?

2. Should the *in pari delicto* defense bar federal securities law claims by an admitted tippee who actively pursued material inside information, traded upon it without disclosure in the public securities markets, and, under the Securities Exchange Act, behaved with at least the same degree of scienter as the alleged tipper-broker?

3. Should this Court endorse refusal to apply the *in pari delicto* defense in implied securities fraud actions based upon the concepts articulated in *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), although *Perma Life* concerned expressly granted statutory antitrust actions and the defense of *in pari delicto* was limited for policy reasons absent in tippee versus tipper securities fraud suits?

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Petitioner Bateman Eichler, Hill Richards, Incorporated ("BEHR"), one of the defendants in a securities fraud action below, respectfully prays that a writ of certiorari issue to review the order of the United States Court of Appeals for the Ninth Circuit entered in this proceeding on April 13, 1984 and modified on denial of rehearing on July 26, 1984. That order, *conflicting expressly with the decisions of all other courts of appeal confronted with the issue,* refused to allow the common law *in pari delicto* defense in a tippee versus tipper civil securities fraud action, primarily because the alleged tipper was a broker or corporate officer, even though (i) the rights of action involved are not expressly granted by the statutes at issue but are implied by the courts and (ii) the plaintiffs-tippees violated the very same statutes with a degree of culpability at least equal to that of the alleged tippers.

The parties to the proceedings below are:

Petitioner here and Defendant/Appellee below, BATEMAN EICHLER, HILL RICHARDS, INCORPORATED, a corporation;[1]

Respondents here and Plaintiffs/Appellants below, CARL F. BERNER, an individual, CHARLES BRUNER, an individual, DENNIS T. DEMETRE, an individual, LAWRENCE EPSTEIN, an individual, BARRY S. GLASS, an individual, HERBERT GREENBAUM, an individual, ROBERT M. JACOBS, an individual, ARNOLD R. KEILES, an individual, HARRY MITTLEMAN, an individual, and GARRY L. NOBEL, an individual; and

Respondents here and Defendants/Appellees below, CHARLES P. LAZZARO, an individual, LESLIE L.

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[1]Petitioner Bateman Eichler, Hill Richards, Incorporated has the following parent company: Batehill, Inc., which in turn is a wholly-owned subsidiary of Kemper Corporation.

Except as aforesaid, petitioner has no parent company, subsidiary, or affiliate within the meaning of Supreme Court Rule 28.1.

NEADEAU, an individual, and T.O.N.M. OIL & GAS EXPLORATION CORPORATION, a corporation.

In addition, the SECURITIES AND EXCHANGE COMMISSION appeared as Amicus Curiae before the Ninth Circuit Court of Appeals.

OPINIONS BELOW

The Opinion of the Court of Appeals rendered April 13, 1983 and amended July 26, 1984 is reported at 730 F.2d 1319 (9th Cir. 1984). The original Opinion is Appendix A to this Petition ("App. A-1"). The Order of the Court of Appeals amending the Opinion and denying rehearing and rehearing en banc was entered July 26, 1984 and is Appendix B to this Petition ("App.B-1"). The unreported Order of the United States District Court for the Central District of California was entered April 18, 1983 and is Appendix C to this Petition ("App.C-1").

JURISDICTION

The judgment of the Court of Appeals was entered on April 13, 1984. A Petition for Rehearing with a Suggestion for Rehearing En Banc was timely filed on April 30, 1984. The Petition for Rehearing was denied and the opinion was modified by an updated order entered July 26, 1984. This Petition for Writ of Certiorari is being timely filed within 90 days thereafter. (28 U.S.C. § 2101(c); Supreme Court Rule 20.2, 20.4). The jurisdiction of the Supreme Court is invoked pursuant to 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

This case involves the usual securities anti-fraud statutes and rule, Sections 17(a) of the Securities Act of 1933 (the "Securities Act"), 15 U.S.C. § 77q; Section 10(b) of the Securities Act of 1934 (the "Securities Exchange Act"),

15 U.S.C. § 78j; and Securities Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5, each of which is printed in full in Appendix D ("App. D-1").

The issue presented in the Petition also is affected by Section 16 of the Securities Act, 15 U.S.C. § 77p; Section 28(a) of the Securities Exchange Act, 15 U.S.C. § 78bb; and the enforcement provisions of the recently enacted Insider Trading Sanctions Act of 1984.

Section 16 of the Securities Act, 15 U.S.C. § 77p, states:

> The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity.

Section 28(a) of the Securities Exchange Act, 15 U.S.C. § 78bb, contains the same provision.

The enforcement provisions of the Insider Trading Sanctions Act, § 2, 1984 U.S. Code Cong. & Ad. News (98 Stat.) 1264, to be codified at Section 21(d)(2) of the Securities Exchange Act, 15 U.S.C. § 78u(d)(2), state in full:

> (A) Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material nonpublic information in a transaction (i) on or through the facilities of a national securities exchange or from or through a broker or dealer, and (ii) which is not part of a public offering by an issuer of securities other than standardized options, *the Commission may bring an action in a United States district court to seek*, and the court shall have jurisdiction to impose, *a civil penalty* to be paid by such person, or any person aiding and abetting the violation of such person. The amount of such penalty shall be determined by the court in light of the facts and circumstances, but shall not

exceed three times the profit gained or loss avoided as a result of such unlawful purchase or sale, and shall be payable into the Treasury of the United States. If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission shall refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court. The actions authorized by this paragraph may be brought in addition to any other actions that the Commission or the Attorney General are entitled to bring. For purposes of section 27 of this title, actions under this paragraph shall be actions to enforce a liability or a duty created by this title. The Commission, by rule or regulation, may exempt from the provisions of this paragraph any class of persons or transactions.

(B) No person shall be subject to a sanction under subparagraph (A) of this paragraph solely because that person aided and abetted a transaction covered by such subparagraph in a manner other than by communicating material nonpublic information. Section 20(a) of this title shall not apply to an action brought under this paragraph. No person shall be liable under this paragraph solely by reason of employing another person who is liable under this paragraph.

(C) For purposes of this paragraph "profit gained" or "loss avoided" is the difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information. (Emphasis added).

STATEMENT OF THE CASE

In this case, admitted tippee-stock purchasers, armed with what they belived to be material inside information,

defrauded the sellers of the stock in a multitude of open market transactions and now are trying to recover their anticipated but unrealized profits and to recoup their losses from their alleged tippers on the premise that the "tips" were spurious.[2] The decision of the Court of Appeals for the Ninth Circuit enables these plaintiffs to utilize the process of the federal courts to preserve the fruits of their own fraud, free of the *in pari delicto* defense.[3]

The Complaint presents claims for violation of federal and state securities laws as well as for state statutory and common law fraud. The only claims at issue in this Petition are those under Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b); Rule 10b-5, 17 C.F.R. 240.10b-5; and Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a).[4] Jurisdiction of the District Court was invoked under Section 22 of the Securities Act, 15 U.S.C. § 77v, and Section 27 of the Securities Exchange Act, 15 U.S.C. § 78aa.

The District Court granted the motion of defendants BEHR and Lazzaro to dismiss the Complaint under Federal Rule of Civil Procedure 12(b)(6) and dismissed it as to all

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[2]Although the decision of the District Court was based upon a motion to dismiss, the facts underlying the *in pari delicto* defense are fully developed. Perhaps to present the issue squarely, plaintiffs pled in extensive detail facts demonstrating their knowing receipt of putative confidential inside information and use of such information to purchase stock at an assumed bargain price, thereby defrauding their sellers.

[3]The decision of the Court of Appeals is not dependent upon further factual development at trial. Rather, its clear-cut holding is that an alleged tipper-broker defendant may not assert or prevail upon the *in pari delicto* defense against the plaintiff customer-tippee.

[4]The Ninth Circuit affirmed the District Court's dismissal of an additional purported federal securities law claim under Section 15 of the Securities Exchange Act, 15 U.S.C. § 78o, which is not in issue here.

defendants. The court therefore necessarily accepted as true the material, well-pleaded allegations of plaintiffs' complaint. Plaintiffs appealed the dismissal to the Ninth Circuit Court of Appeals, and the Securities and Exchange Commission filed a brief as amicus curiae and presented oral argument there.

The Complaint sets forth all the facts necessary for application of the *in pari delicto* defense. It alleges that plaintiffs purchased T.O.N.M. Oil & Gas Exploration Corporation stock expressly "on the premise" that information plaintiffs had received from Lazzaro, a BEHR broker, was "not information available to the general public." (App.A-2; 730 F.2d at 1320). According to the Complaint, Lazzaro induced plaintiffs to purchase T.O.N.M. stock by telling them that T.O.N.M. had acquired rights to a large gold deposit discovered in Surinam, that it was about to enter into a joint venture agreement with a large mining company to mine the gold, that it would issue to its shareholders stock in its subsidiary without additional consideration, and that for these reasons the value of T.O.N.M. stock would increase dramatically from $1.50 per share to between $10 and $15 per share when T.O.N.M. publicly released the information. *Id.*[5]

Plaintiffs did not passively rely on this information. Instead, they undertook to confirm it before commencing a massive purchasing plan which required, for its success, that plaintiffs withhold these "tips" from the other parties to their trades. Plaintiffs thus contacted T.O.N.M. president Leslie Neadeau to verify the accuracy of their "tips," but Neadeau would neither confirm nor deny them. Significantly, plaintiffs did learn from Neadeau, however, that

[5]Defendants Lazzaro and BEHR deny unequivocally the truth of plaintiff's charges. However, of course, on motion to dismiss the allegations are assumed to be true, *arguendo*.

such information was "not public knowledge" and that Lazzaro was very "trustworthy and a good man." *Id.*

With confidence that they possessed inside information and could obtain stock from innocent sellers at a fraction of its true value, plaintiffs then purchased T.O.N.M. stock in the public markets from November 1979 through much of 1980 without disclosing the information to the sellers. (App. A-2-3; 730 F.2d at 1320). Meanwhile, the price of T.O.N.M. stock did rise to $7 per share in late 1980. Then, with public news that the mining venture would not go forward, the stock fell sharply to less than $1 per share in the second quarter of 1981.

Plaintiffs, unwilling to bear the losses their illegal conduct occasioned, sought by this suit to recover their losses and their anticipated profits from their alleged tippers on the basis that some of the non-public information was false or incomplete. The District Court dismissed the suit on the basis of decisions from the Third and Fifth Circuit Courts of Appeals, denying to such plaintiffs a judicial remedy to obtain the benefits of their own violation of the federal securities laws. (App. A-3; 730 F.2d at 1320).

In a stunning departure from the settled rule that has been adopted by every other circuit court previously confronted with the issue, the Ninth Circuit Court of Appeals reversed and held that these tippees, who traded on material inside information with an intent to defraud innocent investors, are immune from the bar of the *in pari delicto* defense in a lawsuit against their brokers and corporate insiders. The Court below explicitly recognized that it has "reached a result in this matter which is contrary to the views expressed in *Tarasi v. Pittsburg National Bank*, 555 F.2d 1152 (3d Cir.), *cert. denied* 434 U.S. 965 (1971), and *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969)." (App. A-10; 730 F.2d at 1324). The Court did not

mention the decisions of the Eleventh and Fourth Circuits, which upheld the availability of the *in pari delicto* defense in *Silverberg v. Paine, Webber, Jackson & Curtis, Inc.*, 710 F.2d 678 (11th Cir. 1983), concluding that the *in pari delicto* defense was applicable in securities cases although the facts of the particular case before the court there did not warrant applying the defense, and in *Malamphy v. Real-Tex Enterprises, Inc.*, 527 F.2d 978 (4th Cir. 1975), approving application of the *in pari delicto* defense against an investor asserting common law claims.

Even though the Court of Appeals below acknowledged that the plaintiffs-tippees in the present case and in the *Tarasi* and *Kuehnert* cases also "violated the federal securities laws," the Court, without any analysis of plaintiff's conduct here, rejected what it characterized as those courts' conclusion that "a duped investor is equally at fault in the fraud perpetrated against him by his broker or an insider." (App. A-10; 730 F.2d at 1324).

The Court of Appeals' decision is additionally grounded on the fallacious premise that in the securities law context, "[p]ublic policy encourages private actions as enforcement devices for the public interest, even though a windfall may accrue to a wrongdoing plaintiff" (App. A-4-5; 730 F.2d at 1321). The Court of Appeals reached this conclusion by improper reliance on *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), where this Court restricted the circumstances under which the *in pari delicto* defense might be applied to bar private civil *antitrust* actions. Without any analysis of the crucial differences between the enforcement provisions of the federal antitrust laws and the securities laws, including the absence in the securities laws of an express private right of action under Section 17 of the Securities Act or Section 10(b) of the Securities Exchange Act, much less a private right of action for treble civil damages, both

found in the antitrust laws, the Court of Appeals assumed that encouragement of private actions such as this was necessary to serve the market-protecting goals of the Securities Act and the Securities Exchange Act. (App. A-7-8; 730 F.2d at 1322-23). The Court meanwhile disregarded the harm that its conclusion would impose on the securities markets by removing an inhibition to insider trading.

I

THE COURT OF APPEALS' DECISION HAS ERRONEOUSLY SWEPT AWAY THE COMMON LAW DEFENSE OF *IN PARI DELICTO* BASED ON A PURPORTED "POLICY" WHICH THE CONGRESS DID NOT EXPRESS AND ON A "STATUTORY" REMEDY WHICH CONGRESS DID NOT PROVIDE BUT WHICH THE COURTS IMPLIED.

The Court of Appeals' decision erases the common law doctrine of *in pari delicto* to favor private statutory securities fraud claims that would not exist without the importation of that right of action into the securities antifraud statutes. Having sanctioned a private right to damages under the securities antifraud statutes by implication, the Court below now has gone a step further and "found" in those laws an intent to exclude a centuries- old and still honored common law defense.

Yet even the Ninth Circuit Court of Appeals itself had previously recognized that "silence of Congress cannot be construed as an intention to make [common law and equitable] defenses unavailable." *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 213 (9th Cir. 1962), *quoting Straley v. Universal Uranium and Milling Corp.*, 289 F.2d 370, 373-74 (9th Cir. 1961). In *Royal Air*, the Court held that the defenses of estoppel and waiver were available in actions brought under Section 10(b) of the Securities Exchange

Act. *Royal Air Properties, Inc. v. Smith, supra,* 312 F.2d at 213. The Court of Appeals there stated:

> Since civil liability was judicially implied [under Section 10(b)], the appropriate common law defenses should be applicable. . . . *Since courts generally interpret statutes in the context of the common law and Congress has not specifically denied the availability of these defenses, we see no reason why the ordinary defenses of estoppel and waiver should not be applicable.* The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act.

Id. at 213-14 (Emphasis added).

The decision of the Court of Appeals below also ignores the savings clauses of the Securities and Securities Exchange Acts, which each state that "[t]he rights and remedies provided by this subchapter shall be in addition to any and all other rights and remedies that may exist at law or in equity." Section 16 of the Securities Act, 15 U.S.C. § 77p; Section 28 of the Securities Exchange Act, 15 U.S.C. § 78bb.

Furthermore, the Court below has eliminated the *in pari delicto* defense by reference to a "policy" of using private actions to promote securities law enforcement purposes, although the Congress never has expressed this need in its efforts to control insider trading and, indeed, elected not to provide for such private actions when it passed the Insider Trading Sanctions Act, just three months ago, vesting enforcement authority over insider trading solely in the SEC. (Insider Trading Sanctions Act, § 2, 1984 U.S. Code Cong. & Ad. News (98 Stat.) 1264 (to be codified at 15 U.S.C. § 78u(d)(2)).

From the earliest days of common law, the courts have refused to aid plaintiffs whose conduct is equally culpable with that of those they seek to sue. *See, e.g., Williams v. Hedley,* 8 East 378, 381-82, 103 Eng. Rep. 388, 389; 1 J. Pomeroy, Equity Jurisprudence §§ 940-42 (5th ed. 1941). The roots of this *in pari delicto* doctrine and its application in the American legal system run deep in the decisional law of the states, and have continuing vitality to this day.[6]

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[6] *See, e.g. Alabama:* J.C. Jacobs Banking Co. v. Campbell, 406 So. 2d 834 (Ala. 1981); *Arizona:* Graham v. Shooke, 107 Ariz. 79, 482 P.2d 446 (1971); *Arkansas:* Long v. Mabry, 250 Ak. 947, 470 S.W. 2d 319 (1971); *California:* Altschul v. Sayble, 83 Cal. App. 3d 153, 147 Cal. Rptr. 716 (1978); *Colorado:* Branham v. Stallings, 21 Colo. 211, 40 P. 396 (1895); *Connecticut:* Tator v. Valden, 124 Conn. 96, 198 A.169 (1938); *Florida:* Whitelock v. Geiger, 368 So. 2d 372 (Fla. App. 1979); *Georgia:* Nash v. Jones, 224 Ga. 372, 162 S.E. 2d 392 (1968); *Hawaii:* Hawaiian Ocean View Estates v. Yates, 58 H. 53, 564 P.2d 436 (Hawaii 1977); *Idaho:* Williams v. Continental Life & Accident Co., 100 Idaho 71, 593 P.2d 708 (1979); *Illinois:* Merchandise National Bank of Chicago v. Kolber, 50 Ill. App. 3d 365, 8 Ill. Dec. 450, 365 N.E. 2d 688 (1977); *Indiana:* Dan Purvis Drugs, Inc. v. Aetna Life Insurance Co., 412 N.E. 2d 129 (Ind. App. 1980); *Iowa:* Johnson v. United Investors Life Ins. Co., 263 N.W. 2d 770 (1978); *Kansas:* Cullen v. Atchison, Topeka & Santa Fe Rwy. Co., 211 Kan. 368, 507 P.2d 353 (1973); *Kentucky:* Ohio River Pipeline Corp. v. Landrum, 580 S.W. 2d 713 (Ky. App. 1979); *Louisiana:* Goldblum v. Boyd, 341 So. 2d 436 (La. App. 1977); *Maryland:* Crockett v. Crothers, 264 Md. 222, 285 A.2d 612 (1972); *Maine:* Mokarzel v. Vorias, 419 A.2d 1017 (Me. 1980); *Massachusetts:* Berman v. Coakley, 243 Mass. 348, 137 N.E. 667 (1923); *Michigan:* Schrier v. B&B Oil Co., 311 Mich. 118, 18 N.W. 2d 392 (1945); *Minnesota:* McCauley v. Michael, 256 N.W. 2d 491 (Minn. 1977); *Mississippi:* Woodson v. Hopkins, 85 Miss. 171, 37 So. 1000 (1905); *Missouri:* Layman v. Uniroyal, Inc., 558 S.W. 2d 220 (Mo. App. 1977); *Montana:* McManus v. Fulton, 85 Mont. 170, 278 P. 126 (1929); *Nebraska:* Loewenstein, v. Midwestern Investment Company, 181 Neb. 547, 149 N.W. 2d 512 (1967); *New Jersey:* Brooks v. Cooper, 50 N.J. E 761, 26 A. 978 (1893); *New Mexico:* Rio Grande Gas. Co. v. Stahmann Farms, Inc., 80 N.M.

This Court and the lower federal courts repeatedly have returned to the common law as a source of sound principles to guide decisions in cases involving federally-granted rights[7]. Thus, this Court has acknowledged a private right of action for damages under Section 10(b) of the Securities Exchange Act because of nearly four decades of decisions implying this remedy (*Herman & MacLean v. Huddleston*,

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432, 457 P.2d 364 (1969); *New York:* Leonard v. Poole, 114 N.Y. 371, 21 N.E. 707 (1889); *North Carolina:* Bledsoe v. Lumber Co., 229 N.C. 128, 48 S.E. 2d 50 (1948); *North Dakota:* Steuber v. Hastings Heating & Sheet Metal Co., 153 N.W. 2d 804 (N.D. 1967); *Ohio:* Cushman v. Flanagan, 186 N.E. 2d 512 (1962); *Oregon:* Merit v. Losey, 154 Or. 89, 240 P.2d 933 (1952); *Pennsylvania:* Feld and Sons, Inc. v. Pechner, Dorfman, Wolfee, Rounick and Cabot, 458 A.2d 545 (Pa. Super. 1983); *Rhode Island:* Gaynor v. Wax, 50 R.I. 194, 146 A. 814 (1929); *South Carolina:* Parr v. Parr, 268 So. C. 58, 231 S.E. 2d 695 (S.C. 1977); *South Dakota:* Degen v. Bayman, 86 S.D. 598, 200 N.W. 2d 134 (1972); *Texas:* General Electric Credit Corp. v. Smail, 584 S.W. 2d 690 (Tex. 1979); *Utah:* Gorringe v. Read, 23 Utah 120, 63 P. 902 (1901); *Virginia:* America-Lafrance v. Arlington County, 169 Va. 1, 192 S.E. 758 (1937); *Washington:* Goldbert v. Sanglier, 96 Wash. 2d 874, P.2d 1347 (1982); *Wisconsin:* General Split Corp. v. P & Atlas Corp., 91 Wis. 2d 119, 280 N.W. 2d 765 (1979).

[7]For example, in *Briscoe v. LaHue*, ____ U.S. ____, 103 S.Ct. 1108 (1983), Mr. Justice Stevens, speaking for the Court, summarized the history of English and American common law in holding that a federal statutory civil rights claim would not lie against a police officer alleged to have given perjured testimony at the claimant's criminal trial because the common law granted parties and witnesses immunity from subsequent damage liability for their judicial testimony. *See Butz v. Economu*, 438 U.S. 478, 501-04 (1978); *Pierson v. Ray*, 386 U.S. 547, 553-54 (1967).

This Court similarly adverts to historical antecedents when it weighs constitutional claims, as when it reconsiders arguments that the Sixth Amendment guarantees the right of the public and the press to attend criminal trials, *Richmond Newspapers, Inc. v. Virginia*, 448 U.S. 555, 574 (1980), or pre-trial suppression hearings, *Gannett Co. v. De Pasquale*, 443 U.S. 368, 384, 386 n.15 (1979).

459 U.S. 375, 380 (1983)), which began with the application of common law principles to a securities law fraud violation in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946). The court held in *Kardon* that the right to recover damages arising from a violation of Section 10(b) and Rule 10b-5 "is so fundamental and so deeply ingrained in the law that where it is not expressly denied the intention to withhold it should appear very clearly and plainly." *Id.* at 514.

Yet the Court below has lightly elevated this implied private right of action above the correlative right of the common law *in pari delicto* defense to claims by those who themselves act illegally. As demonstrated in Section IV of this Petition, this dispatching of the defense is quite a different matter from this Court's treatment of the defense in *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), where this Court was faced with a plaintiff whose conduct was much less culpable than defendant's and with an antitrust statute that, by virtue of its express "private attorney general" provision for private treble damages actions, was deemed to weigh much more heavily against application of the common law defense in many antitrust situations.

II

THE DECISION BELOW CONFLICTS WITH DECISIONS OF OTHER COURTS OF APPEAL BY PERMITTING A DEFRAUDING TIPPEE WHO TRADES ON INSIDE INFORMATION TO AVOID AN *IN PARI DELICTO* DEFENSE WHEN HE SUES A TIPPER FOR SECURITIES FRAUD.

The Courts of Appeals of every other circuit that has dealt with this issue have concluded that when an investor trades on what he believes to be material non-public infor-

mation, the *in pari delicto* defense can and should bar the investor's suit against his purported tipper. *See, e.g., Silverberg v. Paine, Webber, Jackson & Curtis, Inc.*, 710 F.2d 678 (11th Cir. 1983); *Wolfson v. Baker*, 623 F.2d 1074 (5th Cir. 1980), *cert. denied*, 450 U.S. 966 (1981); *Tarasi v. Pittsburgh National Bank*, 555 F.2d 1152 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977); *Malamphy v. Real-Tex Enterprises, Inc.*, 527 F.2d 978 (4th Cir. 1975); *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969).

In addition, four of the five district courts which have considered the question have refused to permit a tippee to avoid the *in pari delicto* defense when he trades on what he believes to be material non-public information and then attempts to sue his tipper. *Compare, e.g., In re Haven Industries, Inc.*, 462 F.Supp. 172 (S.D.N.Y. 1978); *Kirkland v. E.F. Hutton and Co., Inc.*, 564 F.Supp. 427 (E.D. Mich. 1983); *Summerlin v. Blyth Eastman Dillon & Co.*, Fed. Sec. L. Rptr. (CCH) ¶ 99,197 (N.D. Ga. 1983); *and Grumet v. Shearson/American Express, Inc.*, Fed. Sec. L. Rptr. (CCH) ¶ 99,243 (D.N.J. 1983), which have upheld the defense, *with Nathanson v. Weis, Viosin, Cannon, Inc.*, 325 F. Supp. 50 (S.D.N.Y. 1971), the sole district court which rejected it.

The primary rational of these decisions is that if the *in pari delicto* defense is not allowed, the tippee will have a virtual guarantee as to the veracity of any tip and thus will have every economic incentive to trade, without disclosure, on what he believes to be inside information whenever it comes his way. That is, if the tip is correct, the tippee will reap his profit at the expense of the innocent investing public, and if the tip is false, so long as he is able to sue his alleged tipper, any financial loss will be recovered. Giving a tippee such a no-risk or low-risk investment guarantee can do nothing but increase the amount

of attempted insider trading in the securities markets. Thus, the *in pari delicto* defense must be allowed.

An additional rationale recognized by these cases is that absent some strong contravening public policy, wrongdoers should not be permitted to use, and thus pervert, the judicial system by invoking its processes to recover for their illegal, but unsuccessful, schemes. The following Section demonstrates that no such strong, contravening policy is present here so as to override the common law wisdom underlying the *in pari delicto* defense.

III

THE *IN PARI DELICTO* DEFENSE SHOULD BAR THE CLAIMS OF INVESTOR TIPPEES BECAUSE THEIR CONDUCT IS AT LEAST EQUALLY CULPABLE WITH THAT OF THEIR TIPPERS.

After observing that "[t]he Supreme Court has not considered the applicability of the *in pari delicto* defense as an absolute bar to private actions under the federal securities laws," (App. A-5; 730 F.2d at 1321), the Court of Appeals first reviewed this Court's, and its own, treatment of the defense in *antitrust* actions. Then, despite the recognition in the Third and Fifth Circuits of the inapplicability of antitrust doctrine to a securities violation, misapplied this Court's decision in *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), in order to reject the defense.

The Court of Appeals did so without any analysis of the facts behind the two policy underpinnings of the *Perma Life* decision and hence without recognition that the principles behind the denial of an *in pari delicto* defense in *Perma Life* are wholly inapposite to the securities tipper-tippee context. The keystone of Mr. Justice Black's major-

ity opinion was a dual finding, neither element of which is present here: (1) that the plaintiffs there could not be said to be equally responsible for the illegal provisions of the dealership agreement they challenged; and (2) that the Clayton Act's express treble damage "private attorney general" provision evinced Congress' belief that enforcement of national antitrust policy was paramount to otherwise available common law defenses. This Petition addresses the latter issue in Section IV.

The Court of Appeal below noted its agreement with the approach suggested by Mr. Justice White in his concurring opinion in *Perma Life*, 392 U.S. at 146-47, which would deny recovery in a private antitrust action where plaintiff and defendant bear substantially equal responsibility for the injury to one of them. The Court of Appeals here, however, conducted no analysis whatever of the nature and culpability of the conduct of plaintiffs as compared with defendants' alleged conduct and made no determination of the impact of plaintiffs' misconduct on the securities markets.

In rejecting the decisions and reasoning of the other circuits, the Court below also paid no heed to those opinions' central element: By definition a tippee who trades on what he believes to be inside information without disclosing it acts with at least the same degree of scienter as a tipper who disseminates the false inside information. The Court of Appeals' opinion thus holds a securities professional or corporate officer to a higher duty to the market than a tippee-investor, even though it is the tippee whose conduct causes the direct adverse impact on the market.

One of the first decisions to recognize that insider trading will be encouraged if the *in pari delicto* defense is eliminated was *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969), a case quite similar to the present one. There, plaintiff Kuehnert alleged that the president of defendant

Texstar secretly told him that Texstar was about to merge with another company, and that the merger would increase greatly the value of Texstar's stock. Relying on such inside information, Kuehnert thereafter purchased a great deal of Texstar stock on the open market. The tip turned out to be false, the price of the stock fell, and Kuehnert sued the president and Texstar under Rule 10b-5 to recover his losses.

The Fifth Circuit Court of Appeals held that Kuehnert was barred from recovering against his alleged tipper on the ground of *in pari delicto*. The court in *Kuehnert* reasoned that the most effective way to deter tippees from trading on what they believe to be inside information is to remove the tippee's guarantee and to allocate the risk of financial loss upon the tippee-trader in the event of a false tip:

> If a tippee can sue he has, in effect, an enforceable warranty that secret information is true. It is then that he will have free rein. If what he is told is false, he can recover against his informer. If it is true, he will, of course, be liable to his vendors or vendees, but here he may well be protected by the difficulties of discovery. It may be relatively easy to trace insiders; tippees are another matter.
>
> The growth of 10b-5 actions has not thus far been handicapped observably by the absence of suits by tippees against insiders. Nor do we believe that *in pari delicto* and unclean hands have limited the effectiveness of the proxy regulations. Therefore, in view of the substantial deterrent pressures already felt by the corporate insider, *SEC v. Texas Gulf Sulphur Co.*, [401 F.2d 833 (2nd Cir. 1968), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969)], we think it important that tippees, who present the same threat to the

> investing public as do insiders themselves, should be offered appropriate discouragement. We conclude that the better choice is to leave upon persons believing themselves tippees the restraint arising from the fear of irretrievable loss should they act upon a tip which proves to have been untrue. Hence the loss must lie where it falls.

412 F.2d at 705 (footnotes omitted).

This identical concern echoes throughout the decisions of the other courts (except for that of the Ninth Circuit in this case) faced with the question of who should bear the risk of loss in tippee versus tipper civil litigation. For example, in *Tarasi v. Pittsburgh Nat'l Bank*, 555 F.2d 1152 (3rd Cir.), *cert. denied*, 434 U.S. 965 (1977), the Third Circuit Court of Appeals also was faced with a situation much like the present, in which the plaintiff admitted he purchased securities on the premise that the information he received from an "insider" (a loan officer at his bank) was not otherwise available to the general investing public.

When the rumor of an upcoming merger proved to be wrong and the value of plaintiff's securities fell, he brought suit against the bank under Rule 10b-5. In holding that the most effective way to further the policy of deterring future insider trading violations was to deny any admitted wrongdoer-tippee the right to recover his losses from an illegal scheme gone awry, the court recognized that:

> [T]he danger of eliminating *in pari delicto* is that such a stance would give "tippees" almost no incentive to forebear from using inside information. This is so since if the suggested purchase proved unprofitable, the "tippee" might have recourse against his "tipper" on account of the inaccurate leak. The threat of application of *in pari delicto* would eliminate the warranty of the accuracy of the tip that might otherwise exist.

555 F.2d at 1163-64 (footnotes omitted).

See also In re Haven Industries, Inc., 462 F. Supp. 172, 179-80 (S.D.N.Y. 1978), upon which the District Court in the present action relied in upholding the validity of the *in pari delicto* defense ("[E]limination of the *in pari delicto* defense eliminates any incentive for the 'tippee' to refrain from using inside information . . . [because] [i]f what has been disclosed is false, he can recover against the tipper; if the inside information is true, he is virtually certain to make an illegal profit"); *Wolfson v. Baker*, 623 F.2d 1074, 1082 (5th Cir. 1980), *cert. denied*, 450 U.S. 966 (1981) ("[A]ny deterrent effect of threatened liability on the broker may well be more than offset by the inducement to violations inherent in the prospect of a free ride for the customer who . . . is placed in the enviable position of 'heads-I-win tails-you-lose' ").

A. Under the Antifraud Provisions of the Federal Securities Laws, an Investor Owes the Same Duty to the Market as a Securities Professional.

The result below ignores the explicit statutory language of the Securities Act and the Securities Exchange Act which proscribe fraudulent conduct by "any person", ignores the high level of culpability that the trading tippee by definition possesses, and fails entirely to recognize the dynamics of the harm to the market that trading on inside information causes.

The federal securities statutes and rule in issue here govern the rights and duties of *all* investors, not just securities professionals, when they explicitly set one standard for all by proscribing fraudulent conduct by "any person." Securities Act Section 17(a), 15 U.S.C. § 77q(a); Securities Ex-

change Act Section 10(b), 15 U.S.C. § 78j(b); Rule 10b-5, 17 C.F.R. 240.10b-5. These provisions do not limit their application only to conduct by brokers and corporate officers, nor do they impose any hierarchy of guilt or liability.

The only theory that could support the Court of Appeals' finding of inequality as a matter of law is one which posits a higher duty to the market for securities professionals or corporate officers than for tippee-investors. Yet if a hierarchy of culpability were to be created, the tippee who trades on what he believes to be material inside information without disclosing that information to the other party to his transaction would be the more guilty party. The Complaint here is rife with allegations that show that plaintiffs' conduct was grossly culpable under the federal securities laws. Plaintiffs admitted that they believed they had material inside information about a stock and, acting with scienter (here knowing intent, not the mere recklessness which is sufficient to establish liability under the Securities Exchange Act in the Ninth Circuit, *Nelson v. Serwold*, 576 F.2d 1332, 1337 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978)), they fraudulently failed to disclose that information when they traded with innocent investors who only had access to public information about the stock.

The culpability and the mental state of the tippee-plaintiffs and of the alleged tippers therefore were exactly the same, based on the allegations of the Complaint. Thus, the "fault" of the parties under the antifraud statutes is at least equal. Indeed, the fault could even be unequal, with the *tippee* bearing a greater level of scienter than the tipper, who could merely be acting recklessly. Yet in the Ninth Circuit the tippee-trader who dupes the other parties to his transaction may now turn around and sue his broker or corporate insider to recover his losses if the tip proves false and his expected profits do not materialize.

Counsel for Petitioner have not uncovered any basis in the language or history of any other provisions of the federal securities laws applicable to brokers and investors as well which would impose a higher duty on securities professionals. To the contrary, the Second Circuit Court of Appeals recently explicitly rejected the notion that a broker or corporate officer owes a special duty to the market by virtue of his profession. *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5, 15 (2d Cir. 1983), *cert. denied*, ____ U.S. ____, 104 S.Ct. 1280 (1984), *citing* this Court's opinion in *Dirks v. SEC*, ____ U.S. ____, 103 S.Ct. 3255 (1983).

B. The Investor-Tippee Is the Person Who Directly and Adversely Affects the Market When He Trades Without Disclosing What He Believes to be Inside Information.

The dichotomy drawn in the Court of Appeals' opinion is all the more incongruous because it shields the very persons who are directly causing the damage to the securities markets that the Congress sought to prevent when it enacted the Securities and Securities Exchange Acts. A broker's dissemination of false information about a company does not alter the price of that company's stock or otherwise harm its holders or sellers. But the tippee who trades in the stock, thinking he has an informational advantage over the innocent investor, directly causes an adverse impact on the market. Plaintiffs here thus harmed the market as much as, if not more than, their broker and corporate insiders are alleged to have.

IV

CONGRESSIONAL ACTION, SECURITIES AND EXCHANGE COMMISSION INVOLVEMENT, AND PUBLIC REACTION ALL REVEAL THAT APPLICATION OF THE *IN PARI DELICTO* DEFENSE IN SECURITIES ACTIONS IS AN ISSUE OF NATIONAL IMPORTANCE AND REQUIRES UNIFORM TREATMENT BY THIS COURT.

As soon as the District Court reached its decision here and plaintiffs appealed, the Securities Exchange Commission ("SEC") recognized the national importance of the case and appeared as amicus curiae. The case has now had the impact that the SEC hoped for. The Ninth Circuit Court of Appeals' departure from well-settled law, which in all other circuits bars tippees who act illegally from using the courts to enforce the benefits of their illegal bargains, has already gained national attention, both in the media and within the securities industry. *See, e.g.*, The National Law Journal, May 7, 1984, at 11, col. 1; Los Angeles Times, April 14, 1984, Part IV, at 1, col. 5; The Los Angeles Daily Journal, April 16, 1984, at 1, col 4.

Furthermore, the subject of insider trading itself has been the recent focus of greatly intensified discussion nationwide among securities industry analysts and securities professionals, has become a priority target of the SEC, and most recently has had the attention of the United States Congress, which less than three months ago codified the national will in the Insider Trading Sanctions Act of 1984. This Act provides the SEC, but *not* private litigants, with authority to seek treble damages for losses caused by, or profits won by, any purchaser or seller who trades on material non-public information in violation of the Securities Exchange Act. The Congress clearly felt the subject deserving of uniform national treatment. Equally

clearly, the Congress did not see any compelling national policy requiring assistance from private litigants in enforcing bans on insider trading. The "policy" arguments of the Court of Appeals below thus are factually unfounded, and the Ninth Circuit's reliance on those arguments, which has resulted in an inconsistent standard for liability in this circuit, calls for action by this Court to restore national uniformity.

V

THE NINTH CIRCUIT'S EXTENSION OF THIS COURT'S ANTITRUST DECISION IN *PERMA-LIFE* TO PERMIT SECURITIES FRAUD CLAIMS BY TIPPEES WHOSE CONDUCT IS AT LEAST EQUALLY CULPABLE WITH THAT OF THEIR TIPPERS IS UNWARRANTED UNDER THE EXPLICIT TERMS OF THE *PERMA-LIFE* DECISION AND CONTRARY TO THE RECENTLY ENACTED INSIDER TRADING SANCTIONS ACT.

The Court of Appeals below was willing to set aside the American judicial system's traditional distaste for providing a recovery forum for those whose conduct is unlawful because it apparently believed, without any basis in the record or otherwise, that "[t]he possibility of private action is necessary to deter the insider-tipster from knowingly passing on false information to the investing public." (App. A-9; 730 F.2d at 1323). As noted in the Statement of the Case and in Section III above, the Court of Appeals apparently felt compelled to read its result in light of this Court's decision in the antitrust case of *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968). The Court of Appeals' decision, however, ignores the crucial distinction between the two bodies of law that renders the *Perma Life* decision inapplicable here: Congress, in the antitrust laws, explicitly provided for private actions with

treble damage penalties to foster private enforcement of competition laws. In the securities laws, Congress not only failed to provide an express private right of action for securities fraud in the Insider Trading Sanctions Act of 1984, it provided for enforcement of its treble penalty provisions by the SEC only.

The Court of Appeals' decision also disserves the policies of the securities laws it purports to guard. The Court relegated to a footnote the recognition in the Fifth and Third Circuits of the flaw in its market protection theory and, without any analysis of the market effects of its own decision, disputed those courts' well-reasoned conclusion that permitting recovery by non-disclosing tippees would eliminate a necessary deterrent to unlawful tippee conduct and provide such a tippee with a warranty of no loss.

Under the Ninth Circuit rule, the tippee may now trade with impunity. If the information is intentionally false, he may sue his broker or officer tipper to recover his losses or his expected profits. If the information proves wrong, but his tipper did not act fraudulently, he will likely profit by his trades as the market rises or falls in response to the dissemination of the inside information (as plaintiffs allege it did here (App. A-3; 750 F.2d at 1323)), and the other parties to his trades will suffer, but will in most cases never be able to find him. Finally, if the information proves true, he will reap a bonanza with little fear of detection by the SEC or of location by the other parties to his trades. The Ninth Circuit Court of Appeals' decision has thus fostered the very insider trading that Congress has just attempted to reduce.

CONCLUSION

To re-establish uniformity of decisions, promote the sound public policy articulated in the common law, and restore a fair balance between the rights of plaintiffs and defendants in implied rights of action under the securities antifraud laws, a writ of certiorari should issue to review the judgment and opinion of the Court of Appeals for the Ninth Circuit.

Respectfully submitted,

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APPENDIX A

Opinion.

United States Court of Appeals for the Ninth Circuit. No. 83-1972, D.C. No. C-82-6717-WWS. Carl F. Berner, Charles Bruner, Dennis T. Demetre, Lawrence Epstein, Barry S. Glass, Herbert Greenbaum, Robert M. Jacobs, Arnold R. Keiles, Harry Mittleman and Gary L. Nobel, Plaintiff-Appellants vs. Charles P. Lazzaro; Bateman Eichler, Hill Richards Incorporated, Leslie L. Neadeau, and T.O.N.M. Oil & Gas Exploration Corporation, Defendants-Appellees.

Filed: April 13, 1984.

Appeal from the United States District Court for the Northern District of California. William W. Schwarzer, District Judge, Presiding. Argued and submitted February 15, 1984.

Before: ANDERSON, SCHROEDER, and ALARCON, Circuit Judges, Alarcon, Circuit Judge:

Appellants seek a reversal of the judgment of the district court granting appellees' motion to dismiss the complaint pursuant to Federal Rule of Civil Procedure 12(b). The trial court determined that the application of the *in pari delicto* doctrine barred appellants from any right to recovery. Because we feel that securities professionals and corporate officers who have allegedly engaged in fraud should not be permitted to invoke the *in pari delicto* doctrine to shield themselves from the consequences of their fraudulent misrepresentation, we reverse and remand for a trial on the merits of appellants' claims.

For purposes of reviewing the lower court's dismissal of appellant's action for failure to state a claim, we must accept the facts alleged in the complaint as true. *California Dump Truck Owners Assn., Inc. v. Associated General Contractors of America*, 562 F.2d 607, 614 (9th Cir. 1977).

PERTINENT FACTS

Appellant's complaint alleges that Charles Lazzaro, a registered representative of the broker dealer firm Bateman Eichler, Hill Richards, Inc., and Leslie Neadeau, president of T.O.N.M. Oil and Gas Exploration Corporation, conspired to manipulate the market price of T.O.N.M. stock by disseminating false information on the pretext that it was inside information.

T.O.N.M. common stock is traded over the counter through the National Association of Securities Dealers System. Appellants purchased T.O.N.M. stock through Lazzaro and other brokers "on the premise" that Lazzaro was privy to "certain information not otherwise available to the general public." Lazzaro allegedly induced appellants to purchase T.O.N.M. stock by representing to them that he knew T.O.N.M.'s president personally and by telling them the following material nonpublic information about T.O.N.M.: it had acquired the rights to a large gold deposit discovered in Surinam; it was about to enter into a joint venture agreement with a large mining company to mine the gold; it would issue to its shareholders stock in its subsidiary without additional consideration; and as a result of these developments the value of T.O.N.M. stock would increase dramatically. He told appellants that the price of T.O.N.M.'s stock would increase from $1.50 per share to between $10 and $15 per share upon publication of the information. Appellants sought confirmation of the foregoing information from Neadeau. He would neither confirm nor deny it. Instead he said that such information was "not public knowledge" and that Lazzaro was very "trustworthy and a good man."

The complaint alleges that these false representations were made with knowledge of their falsity with the intention of creating an artificially high demand and price for such

stock. The representations are alleged to be false or materially incomplete. Appellants purchased T.O.N.M. stock in reliance on the defendants' misrepresentations and as a result of their unlawful scheme.

The price of the stock rose to $7 per share in the latter part of 1980 as a result of the defendants' manipulation. In the second quarter of 1981, the stock fell sharply to less than $1 per share. Thereafter, appellants sold their T.O.N.M. stock at prices substantially below those at which they purchased the stock.

The district court dismissed appellants' damage claim under § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder on the ground that appellants were *in pari delicto* with Lazzaro and Neadeau. The court explained that appellants had admitted in their complaint "that they had acted on insider information and therefore were tippees." "If the allegations of the complaint are true," the court stated, "both plaintiffs and defendants violated the particular statutory provision under which recovery is sought." The district court concluded that under such circumstances the *in pari delicto* doctrine automatically barred plaintiffs' claim without balancing relative fault.

DISCUSSION

This court has not previously addressed the question of the application of the defense of *in pari delicto* to a private action by an investor to recover losses caused by the fraudulent misrepresentations of a broker concerning alleged insider information.

We begin our discussion by noting that *in pari delicto* is a common law doctrine of "complex scope, contents, and effects." *Perma Life Mufflers, Inc. v. International Parts Co.*, 392 U.S. 134, 140 (1968). Although it literally means "of equal fault", *id.* at 138, there is a "lack of agreement on a definition of the term '*in pari delicto*', as well as a

disagreement, perhaps, on the standards that should govern the use of the defense to which the term is properly applied." *Id.* at 153 (Harlan, J. concurring and dissenting).

Historically, the doctrine of *in pari delicto* has been used to protect the integrity of the court where it was called upon to decide between two wrongdoers. *See, Limitations on Defenses Under 10(b): In Pari Delicto and Unclean Hands*, 5 U. Richmond L. Rev. 251, 257 (1971). *In pari delicto* has traditionally been applied in the interest of society, rather than that of individual litigants. 3 Pomeroy, *Equity Jurisprudence*, § 940-941 (5th ed. 1941). Thus, where private suits are encouraged to further specific public policies, the question has often arisen concerning whether the doctrine of *in pari delicto* should be limited in order to advance societal interests. Fisher, *Tipsters, Tippees and the Doctrine of In Pari Delicto*, 50 B.U.L. Rev. 87, 93 (1970). Some courts have refused to allow the interposition of the defense when the defendant's misconduct exceeds that of the plaintiff, or when the defense would be detrimental to the public interest. 3 Pomeroy, § 941.

In *Mallis v. Bankers Trust Co.*, 615 F.2d 68, 76 (2nd Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981), the court noted that "[t]he Supreme Court has not displayed much enthusiasm for the *in pari delicto* defense to claims for violation of federal law even when the plaintiff's violation was of the same statute under which he sought relief. *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968)."

In *Perma Life* the majority commented that "[w]e have often indicated the inappropriateness of invoking broad common-law barriers to relief where a private suit serves important public purposes". *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134, 138 (1968). Public policy encourages private actions as enforcement devices

for the public interest, even though a windfall may accrue to a wrongdoing plaintiff. Murray, *Securities Regulation — In Pari Delicto as a Bar to Private Antifraud Action by Tippee Against Tipper*, 43 Mo. L. Rev. 378, 381 (1978).

The Supreme Court has not considered the applicability of the *in pari delicto* defense as an absolute bar to private actions under the federal securities laws. The Court has reviewed the use of this defense in private antitrust actions. In *Perma Life*, 392 U.S. at 138, a majority of the court held that under the facts before it there was no basis for applying the doctrine of *in pari delicto* in an antitrust action. This court confronted the impact of *Perma Life* on antitrust cases in *Javelin Corp. v. Uniroyal, Inc.*, 546 F.2d 276 (9th Cir. 1976), *cert. denied*, 431 U.S. 938 (1977); Accord, *THI Hawaii v. First Commerce Financial Corp.*, 627 F.2d 991 (9th Cir. 1980).

In *Javelin*, we stated that a plaintiff is not barred from recovering because of the equitable defense of *in pari delicto* unless "the illegal conspiracy constituting the antitrust violation would not have been formed but for the plaintiff's participation." *Javelin*, 546 F.2d at 279. In formulating this test, we noted our agreement with the approach suggested by Justice White in *Perma Life*. *Javelin*, 546 F.2d at 279 n.3. There, Justice White stated:

> I would deny recovery where plaintiff and defendant bear substantially equal responsibility for the injury resulting to one of them but permit recovery in favor of the one less responsible where one is more responsible than the other.

Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 146-47 (White, J. concurring).

Thus, in private antitrust actions, it is the law of this circuit that the doctrine of *in pari delicto* does not apply

where the facts show that the plaintiff is less than co-equally responsible for his injury. We see no valid reason for creating a different rule for private actions initiated under the federal securities laws.

In the matter before us, the complaint alleges that the fraudulent scheme was originated by the broker and his coconspirators to manipulate the market price of T.O.N.M. stock for their financial benefit. The complaint further provides that the investors acted in reliance on these representations without knowledge of the true facts. The allegations of the complaint, if proved, would demonstrate that the investors could not have been equally responsible for the injury they suffered as a result of this fraudulent scheme. Therefore, the complaint should not have been dismissed on the basis of *in pari delicto*.

The purpose of the Securities Exchange Act of 1934 is to compel full and fair disclosure in the issuance of securities so that the investors will be adequately protected. *See U.S. v. Carman*, 577 F.2d 556, 564 (9th Cir. 1978) [discussing 1933 Act]. The legislative history of the enactment of the 1934 Act clearly indicates that the "various abuses . . . and the inadequacy of self-regulation by the stock exchanges" precipitated the need for the legislation. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 204 (1975). "[P]revention of frauds against investors was surely a key part of [the purpose behind the securities act], but so was the effort to achieve a high standard of business ethics . . . in every facet of the securities industry". *U.S. v. Naftalin*, 441 U.S. 768, 775 (1978).

The major objective of the federal securities law is undoubtedly to provide protection to the investing public. *See SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1953). Clearly, at the heart of congressional concern in

enacting the statutes were the abuses committed within the industry, specifically by insiders and brokers.

The Supreme Court has ruled that where the clear legislative purpose of an act or statute would be hindered rather than aided by a judicial sanction prohibiting a right of action by a plaintiff, such sanctions shall not be upheld. In *A.C. Frost & Co. v. Coeur d'Alene Mines Co.*, 312 U.S. 38 (1948), a purchaser of unregistered shares of stock sought to enforce a contract of sale through application of statutory sanctions pursuant to the Securities Exchange Act. The Supreme Court rejected the issuer's defense that the contract be found null and void due to the unlawful misconduct of both parties in negotiating an illegal contract, stating that to deny relief because of the illegality would "seriously hinder rather than aid the real purpose of the statute." *Id.* at 43. Thus, enforcement of the contract was permitted because denial would have encouraged violation of the act and would have defeated its intent.

The rationale of the Supreme Court's decision in *Frost* applies to cases dealing with Section 10 violations brought by investors against defrauding insiders. Section 10 of the act was specifically created to proscribe fraudulent misrepresentations and concealment of material fact by brokers and dealers. Application of the defense in favor of BEHR and Lazzaro and in favor of T.O.N.M. and Neadeau would hinder the purpose and intent of the section. The resources of the Securities Exchange Commission are adequate to prosecute only the most flagrant abuses. *See* A. Bromburg, *Securities Law: Fraud-SEC Rule 10-b-5* §§ 10.1-10.3 (1967). To this end, private actions brought by investors have long been viewed as a necessary supplement to SEC enforcement actions. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975). Even in situations where an investor is not free from blame, private damage actions under these

antifraud and antimanipulation provisions serve not only to compensate injured investors, but also to deter fraud and manipulation by exposing those contemplating unlawful conduct to the threat of private damage liability.[1] "Public confidence in an honest securities marketplace is endangered whenever there are fraudulent activities, even if the accounting of only one investor is involved." Harter, *Rule 10b-5: The In Pari Delicto and Unclean Hands Defenses*, 58 Cal. L. Rev. 1149, 1156 (1970).

Private actions by investors victimized by the fraudulent representations of brokers also protect other investors who were not defrauded from artificial market fluctuations. In the matter before us, appellants allege that the dissemination of false information into the securities market unjustifiably inflated the market value of T.O.N.M. stock. The stock fluctuated from approximately $1.50 a share in 1979 to a high of $7.12 in the fourth quarter of 1980 as a result of the false information. The price crashed down to $1 a share by the end of the second quarter of 1981. This activity may have caused substantial losses for those investors who purchased T.O.N.M. stock in the belief that its price reflected its true market value.

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[1]We agree with Judge Trask's criticism of the use of the common law defenses in the securities area:

> If a limitation upon common law defenses available to a broker might in some instances allow an unscrupulous investor to recover, this consequence is balanced by the salutary effect which the threat of private suits can have in maintaining adherence to statutory commands. . . . Availability of common law defenses, such as *in pari delicto* . . . serve to make this check upon abuses in the system's internal workings considerably less potent.

Hughes v. Dempsey-Tegler & Co., Inc., 534 F.2d 156, 184 (9th Cir.) (Trask, J. concurring and dissenting), *cert. denied*, 429 U.S. 896 (1976).

Any deterrent effect against the use of insider information through imposition of the *in pari delicto* defense is outweighed by the resulting adverse consequence to the market and innocent investors. The defense eliminates any incentive on the part of the injured investor to bring suit, with the result that many violations of the securities act would remain unexposed. Murray, 43 Mo. L. Rev. at 386. Such a decision would tell the corporate insider that if he releases false information which induces action on the part of a would be tippee, he need not fear private enforcement of the securities law. *Id.* "Without the sanction of civil liability, the insider is likely to go undetected and be left to practice his deceit again, with the incentive provided by the knowledge that he is now virtually immune to civil liability for his violation of rule 10b-5." Harter, 58 Cal. Rev. at 1158.

This result is totally incompatible with the overall aims of the securities law, and of Rule 10b-5. The possibility of private action is necessary to deter the insider-tipster from knowingly passing on false information to the investing public. *See* Note, *Securities Regulation: Doctrines of In Pari Delicto and Unclean Hands Held to Bar 10b-5 Recovery by Tippee Against Corporate Insider*, 1969 Duke L. J. 832, 839. The encouragement of this kind if litigation also serves to publicize fraudulent schemes and enables the victims to discover and seek redress for their loss. Fisher, 50 B.U.L. Rev. at 91. To allow professionals in the securities industry and corporate officers to hide behind the *in pari delicto* defense gives them a license to defraud the investing public with little fear of prosecution. So long as these persons disseminated false information on the pretext that it was "inside" information, they would be shielded from liability in a private civil action. The rule we adopt today will further public policy by providing greater pro-

tection for the investing public. *Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50, 52-53 (S.D. N.Y. 1971).

We recognize that we have reached a result in this matter which is contrary to views expressed in *Tarasi v. Pittsburgh National Bank*, 555 F.2d 1152 (3rd Cir.), *cert. denied*, 434 U.S. 965 (1977) and *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969). Both courts upheld orders granting summary judgment on the theory that the investors were *in pari delicto* because they voluntarily committed illegal acts in violation of the federal securities laws.[2] We are not persuaded by the conclusion reached in these circuits that a duped investor is equally at fault in the fraud perpetrated against him by his broker or an insider.

[2]The courts in *Tarasi* and *Kuehnert* were both concerned that permitting a tippee to recover would give him a virtual "warranty of accuracy" on his tips, and thus that he would have no incentive to forbear from using inside information. *Tarasi*, 555 F.2d at 1163; *Kuehnert*, 412 F.2d at 705. *See also In re Haven Industries*, 462 F. Supp. at 179-180. According to this theory, if the tip is correct, the tippee will reap his profit at the expense of the innocent investing public, and, if the tip is false, so long as he is able to sue his alleged tipster his financial loss will be covered.

However, this characterization of the tippee being placed in the position of "heads I win, tails you lose" fails where the investor must allege fraud. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Supreme Court held that to succeed in a private cause of action under Rule 10(b)(5), a plaintiff must prove scienter. Under this rule, a purported tippee does not have a submissible case absent a showing that the tipster possessed an "intent to deceive, manipulate or defraud." *Id.* at 193. "The requirement of scienter erodes any broad 'warranty of accuracy'. The tippee is only warranted against knowing and intentional deceit." Murray, 43 Mo. L. Rev. at 384 n.35.

Far from being guaranteed of success, an investor who trades on inside information has violated Rule 10(b)(5) and subjects himself to potential criminal liability through an action by the SEC. Furthermore, if the tip merely fails to "pan out" or if the information itself proves accurate but the stock fails to move in the anticipated direction, the investor stands to lose all of his investment. Only in the situation where the investor has been deliberately defrauded will he be able to maintain a private suit in an attempt to recoup his money.

CONCLUSION

We have concluded that the defense of *in pari delicto* is inappropriate as the sole basis for the dismissal of a complaint, in a private action under the federal securities laws, unless the alleged facts show that the investor is equally responsible for his injury. Where the pleaded facts show that the investor suffered a loss because he relied upon a broker's fraudulent misrepresentations, a cause of action has been stated which may be answered by denial or barred by pleading and proving an affirmative defense. We reject the notion that a defrauded investor is not entitled to recover damages against a broker or an insider solely because the complaint shows that the plaintiff has violated the federal securities laws. "[A]n investor does not waive or lose the shelter of the Act because he becomes to some extent involved in the illegality of the security sales." *Can-Am Petroleum Company v. Beck*, 331 F.2d 371, 373 (10th Cir. 1964). The judgment is REVERSED.

APPENDIX B

Order.

United States Court of Appeals for the Ninth Circuit No. 83-1972, D.C. No. C-82-6717-WWS. Carl F. Berner, Charles Bruner, Dennis T. Demetre, Lawrence Epstein, Barry S. Glass, Herbert Greenbaum, Robert M. Jacobs, Arnold R. Keiles, Harry Mittleman and Gary L. Nobel, Plaintiff-Appellants. vs. Charles P. Lazzaro; Bateman Eichler, Hill Richards Incorporated, Leslie L. Neadeau, and T.O.N.M. Oil & Gas Exploration Corporation, Defendants-Appellees.

Filed: July 26, 1984.

Before: ANDERSON, SCHROEDER, and ALARCON, Circuit Judges.

The Opinion decided April 13, 1984, has been amended as follows:

A new footnote 1 has been added as follows:

[1]In Footnote 8 of their opening brief, appellants challenge the district court's dismissal of their claim for violation of section 15(c) of the Exchange Act (15 U.S.C. § 780(c). Appellants make no further mention of this contention. The district court correctly dismissed the Section 15(c) claim. No private right of action exists under this section. *Admiralty Fund v. Hugh Johnson & Co.*, 677 F.2d 1301, 1313-14 n.16 (9th Cir. 1982).

By adding this new footnote, the numbering sequence of the footnotes is changed, i.e., the old Footnote 1 becomes Footnote 2, etc.

In the old Footnote 2, on page 1743 of the slip opinion, second column, second line, change the word "through" to "as well as," thus that line will read, "potential criminal liability as well as an action by . . ."

With these changes, the panel has voted unanimously to deny the petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc, and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed R. App. P. 35(b).

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

APPENDIX C

Order.

United States District Court, Northern District of California, No. C-82-6716-WWS. Carl F. Berner, Charles Bruner, Dennis T. Demetre, Lawrence Epstein, Barry S. Glass, Herbert Greenbaum, Robert M. Jacobs, Arnold R. Keiles, Harry Mittleman and Gary L. Nobel, Plaintiffs, v. Charles P. Lazzaro; Bateman Eichler, Hill Richards Incorporated; Leslie L. Neadeau; and T.O.N.M. Oil & Gas Exploration Corporation, Defendants.

Filed: April 18, 1983.

The plaintiffs in this action allege that Charles Lazzaro, a broker employed by Bateman, Eichler, and Leslie Neadeau, president of TONM Oil and Gas Exploration Corp., conspired to defraud them by making misrepresentations which induced them to purchase TONM stock from November 1979 through much of 1980. Lazzaro is alleged to have represented that:

(a) TONM had found gold in Surinam;

(b) TONM would announce in April 1980 a joint venture with St. Joseph's Mining & Mineral Co. to mine the gold; and

(c) the value of TONM stock would rise dramatically as a result of these developments. Plaintiffs purchased their TONM stock "on the premise" that Lazzaro's information was "not information available to the general public" (Complaint, paragraph 15).

No joint venture was announced in April. According to plaintiffs, Lazzaro told them several times that the announcement had been delayed but was still forthcoming. By the last quarter of 1980, the price of TONM stock had risen to $7.00 per share. At the end of that year, the price fell to $1.00 per share and "some or all" of the plaintiffs

sold their shares. In January 1981 TONM finally announced that there would be no joint venture. In September of that year TONM announced that the SEC had named it in an Order for Private Investigation.

All defendants have moved to dismiss the complaint.

Although the complaint is not pleaded with sufficient particularity, there is no need to rule on this point, for it is clear from the pleadings that plaintiffs are not entitled to relief under any federal statute.

Plaintiffs' first claim is for violation of rule 10b-5. Plaintiffs admit that they acted on insider information (albeit false information) and therefore were tippees. Because trading on insider information is itself a violation of rule 10b-5, courts generally have barred such tippees from maintaining rule 10b-5 actions for alleged fraud in connection with the insider information. *Kuehnert v. Texstar Corporation*, 412 F.2d 700, 702 (5th Cir. 1969); *Tarasi v. Pittsburgh National Bank*, 555 F.2d 1152 (3rd Cir.), *cert. denied*, 434 U.S. 965 (1977).

It is quite true that in applying the general doctrine of pari delicto, courts have engaged in a painstaking balancing of relative fault. *See Woolf v. S. D. Cohn & Company*, 515 F.2d 591 (5th Cir. 1975), *reh'g granted*, 521 F.2d 225 (5th Cir. 1975). This case, however, does not raise those difficulties. Here there is no question that if the allegations of the complaint are true, both plaintiffs and defendants violated the particular statutory provision under which recovery is sought. For the reasons well-stated in Judge Gagliardi's opinion in *In re Haven Industries, Inc.*, 462 F. Supp. 172 (S.D.N.Y. 1978), the Court concludes that plaintiffs are barred from recovering on their rule 10b-5 claims.

Plaintiff's reliance on *Xaphes v. Shearson, Hayden, Stone, Inc.*, 508 F. Supp. 882 (S.D. Fla. 1981) is misplaced inasmuch as plaintiff there was found not to have been a tippee. Nor does plaintiffs' argument that the issue may not be decided on the pleadings have merit; all of the material facts have been alleged in the complaint and are accepted as true for purposes of this motion. *See In re Haven Industries, Inc., supra*, and *Kuehnert* and *Tarasi, supra*, in which the issue was decided on summary judgment.

Plaintiffs' second claim (which merely duplicates their rule 10b-5 claim) is for violation of section 15(c) of the Exchange Act, 15 U.S.C. 78o(c). The Ninth Circuit recently held that there is no private right of action under this section. *Admiralty Fund v. Hugh Johnson & Co.*, 677 F.2d 1301, 1314 n.16 (9th Cir. 1982). Only one reported case is to the contrary, *Franklin National Bank v. L. B. Meadows & Co.*, 318 F. Supp. 1339 (E.D.N.Y. 1970), and it is not persuasive in light of the reasoning of more recent cases such as *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 15-16 (1979). Plaintiffs rely on *Opper v. Hancock Securities Corp.*, 367 F.2d 157 (2d Cir. 1966). In that one-page opinion the court simply stated that a broker who failed to carry out a sale order but disposed of his own stock violated "the Securities Exchange Act" and could be held liable "in a private suit." *Id.* at 158. The trial judge had found a violation of the "antifraud provisions" of the Act, citing both § 10(b) and § 15(c) without relying on either one. The § 15(c) claim must therefore be dismissed.

Plaintiffs' third claim is for violation of § 9(a) of the Exchange Act, 15 U.S.C. § 78i(a) (price manipulation). The period of limitations on a private action under this section is one year after discovery. *Id.* § 78i(e). In this

case it is clear from the face of the complaint that plaintiffs were on inquiry notice more than one year before they filed suit on December 10, 1982. Prices had risen and fallen by the end of 1980 when some of the plaintiffs sold their stock to mitigate their damages. In January of 1981 TONM announced that there would be no joint venture, and in September the SEC began its investigation. No facts are alleged supporting a claim that the statute was tolled. This claim is therefore time-barred.

Plaintiffs' fourth claim is for violation of § 17(a) of the '33 Act. Since that section is practically indistinguishable from § 10(b), *see Stephenson v. Calpine Conifers II, Ltd.*, 652 F.2d 808, 815 (9th Cir. 1981), this claim is barred for the same reason as the rule 10b-5 claim.

Plaintiffs' remaining claims arise under state law. In view of the posture of this case, there are no considerations of judicial economy, convenience and fairness to litigants which would justify a federal court taking jurisdiction of matters of state law. *United Mine Workers v. Gibbs*, 383 U.S. 715, 726 (1966).

Accordingly the complaint is dismissed.

IT IS SO ORDERED.

DATED: April 15, 1983

WILLIAM W. SCHWARZER
United States District Judge

APPENDIX D

Statutory Provisions Involved

Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a), states:

> (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly —
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Section 10(b) of the Securities Act, 15 U.S.C. § 78j(b), states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may

prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5, states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.